Nos. 21490 and 21490-A See Vol. 3399

In the United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA, APPELLANT

v.

TRANSAMERICA CORPORATION, APPELLEE

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v.

UNITED STATES OF AMERICA, APPELLEE

On Appeals from the Judgment of the United States District Court for the Northern District of California

BRIEF FOR THE UNITED STATES AS APPELLANT

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
GILBERT E. ANDREWS,
J. EDWARD SHILLINGBURG,
Attorneys,
Department of Justice,
Washington, D. C. 20530.

Of Counsel:

CECIL F. POOLE,
United States Attorney.

RICHARD L. CARICO,
Assistant United States Attorney.

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BRIEF FOR THE UNITED STATES AS APPELLANT

OPINION BELOW

The memorandum of decision of the District Court (R. 19-40) is reported at 254 F. Supp. 504.

JURISDICTION

This appeal involves federal income taxes of the taxpayer corporation for the taxable year 1958. The taxes in dispute were paid on December 10, 1962. (R. 3, 9.) A claim for refund was filed by the taxpayer on June 6, 1963, and was rejected by the Commissioner of Internal Revenue on October 22, 1963. (R. 6, 9.) Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on July 8, 1964, the taxpayer brought this action in the District Court for recovery of the taxes paid. (R. 1-7.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. The judgment of the District Court was entered on July 22, 1966. (R. 41-42.) Within sixty days thereafter, on September 16, 1966, a notice of appeal was filed by the United States, and a notice of appeal was filed by the taxpayer on September 19, 1966. (R. 48, 51-52.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

Whether expenses in the total amount of $176,-046.65, incurred by the taxpayer in connection with the divestiture of its bank holding company business, constitute nondeductible capital expenditures (as the Commissioner determined) or are deductible as ordinary and necessary business expenses (as the District Court held).

STATUTES INVOLVED

The relevant statutes are set out in Appendix A, *infra.*

STATEMENT

The facts material to this appeal as stipulated and found by the District Court (R. 19, 21-23) may be summarized as follows:

Transamerica Corporation (hereinafter referred to as the taxpayer) is a Delaware corporation with its principal place of business in San Francisco, California. It computed its income on the accrual basis of accounting. (R. 12-13.) For several years prior to 1957, the taxpayer controlled through the ownership of capital stock a number of banks, insurance companies, and other businesses. In 1956, Congress enacted the Bank Holding Company Act, c. 240, 70 Stat. 133, which required the taxpayer to consider disposing of either its bank investments or its non-bank investments. The Act provided, in general, that a corporation which was a bank holding company (defined in Section 2 of the Act as a corporation controlling 25% or more of the voting shares of two or more banks) had to dispose of all investments other than bank stocks or, if it did not wish to remain a bank holding company, dispose of all its investments in bank stocks. (R. 13-14, 21.)

The board of directors considered possible courses of action to be taken in view of the Act in their meeting on September 19, 1957. The minutes of the meeting state in part as follows (R. 14; Stip. Ex. E, p. 5):[1]

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[1] The various exhibits attached to the stipulation have been omitted from the transcript of record by stipulation of the

The Chairman recalled the prior discussions before the Board. Emphasis was placed on the necessity of accomplishing the split-up in a manner which would avoid unnecessary taxes and which would assure the continuity and soundness of the various enterprises both from a management viewpoint and having regard to the capital needs and working funds of the various units. He noted that since the initial consideration of this matter by the Board there had been no material change in the financial condition of the Corporation or the prospects of the various subsidiaries which had altered the initial reaction of the Board that adequate capital and sound management for the non-banking businesses as a whole could only be provided by the continuation of all of the Corporation's non-banking subsidiaries in a single corporate entity. Two pro forma balance sheets as of August 31, 1957, showing the condition of Transamerica if all shares which it owned directly in its majority-owned banks were to be placed in a new bank holding company as well as the financial condition of such a bank holding company were then distributed to the Directors for analysis and comment and the Treasurer was asked to compare these pro forma statements with similar pro forma statements as of April 30, 1957, which had been furnished at the June meeting of the Directors. It was generally agreed that the least

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parties, but may be referred to as if set out therein. (R. 61-62.)

Four reproduced copies of the exhibits relied upon by the Government will be supplied to the Clerk and a copy will be mailed to opposing counsel.

disruption of the Corporation's existing business and the maximum realization and utilization of the underlying values in the subsidiaries would be achieved by a transfer of the shares of the majority-owned banks (directly owned by the Corporation) to a separate corporation, the shares of which would be spun off to Transamerica's stockholders, with all of the remaining assets of the Corporation retained by the continuing Transamerica Corporation. After again discussing the advisability of attempting to effect a recapitalization of the Corporation with a view to reducing the number of shares outstanding prior to the spin off, it appeared from the general discussion that in view of the large number of stockholders who hold only a half share of Transamerica Corporation stock or whose holdings include a half share or whose holdings were for a small number of shares and other factors, such a recapitalization would aggravate the present stockholders of the Corporation and would be impractical.

The Board then again reviewed the advantages and disadvantages of each form of reorganization possible under the Act. Following this discussion, it was the unanimous conclusion of the Directors present that the ownership of the directly-owned shares of the majority-owned banks by a single corporate entity, which would be newly created for this purpose and the shares of which would be spun off to Transamerica's stockholders, was highly desirable, and that various corporate, management and fiscal considerations made it equally desirable for Transamerica as a single corporate entity to retain all of the nonbanking businesses.

The details of a proposed plan were discussed and the board approved a plan of reorganization whereby Transamerica would cease to be a bank holding company by transferring all of its bank stock to a new corporation to be organized for that purpose and to be called Firstamerica Corporation (hereinafter referred to as Firstamerica). The taxpayer would receive in exchange for its bank stock all of the capital stock of Firstamerica. Immediately after the exchange, and as a part of the plan of reorganization, the taxpayer was to distribute the Firstamerica stock to the taxpayer's own stockholders. (R. 13-14, 21.) The "PLAN OF REORGANIZATION" approved by the board (Stip. Ex. E, pp. 8-10) is set out in Appendix C, *infra.*

The taxpayer then obtained rulings from the Commissioner of Internal Revenue regarding the tax effect of the reorganization on itself, on Firstamerica, and on the stockholders of the two corporations. (R. 14; Stip. Ex. F.)

The taxpayer's stockholders were advised of the details, purpose and effect of the plan of reorganization by a notice of annual meeting and proxy statement. (R. 14-15; Stip. Ex. H.) In his letter forwarding the notice and proxy statement, the president of the taxpayer noted (Stip. Ex. H, first and second unnumbered pages):

> In essence, this plan contemplates that Transamerica will continue to own and manage its insurance and other non-banking businesses, but will cease to be a bank holding company. To accomplish this, it will transfer to Firstamerica

Corporation, a new corporation organized for this purpose, all of its directly held shares in its majority-owned banks together with $20,000,000 in cash. In exchange for these stocks and cash, Transamerica will acquire all of the stock of Firstamerica, consisting of 11,372,022 shares, and these shares will then be distributed share for share to our stockholders. The Firstamerica shares will be mailed to you as promptly as possible after June 30, 1958, the planned date of the reorganization. Application will be made to list the Firstamerica stock on the Pacific Coast and New York Stock Exchanges.

Stockholders will not be required to surrender any of their Transamerica stock. After the proposed reorganization, you will hold both your Transamerica shares and an equal number of shares of the stock of Firstamerica Corporation. The market values of the Transamerica and Firstamerica shares at that time will, of course, reflect the fact that the present assets of Transamerica have been divided between the two corporations. [Emphasis in original.]

* * * *

In the opinion of your Board, this plan constitutes the best possible method of preserving the values underlying your Transamerica stock while meeting the legal requirements of the situation. We firmly believe that, from the standpoint of continuity and of providing adequately for the management, capital and working fund needs of our present subsidiaries, both banking and non-banking, the proposed plan is far preferential to any other method of compliance.

The proxy statement stated (R. 22; Stip. Ex. H, p. 3):

> Immediately after the distribution, the stockholders of Transamerica will be the owners of two corporations, which will own the same assets owned by Transamerica immediately prior to the distribution. The two corporations will be Transamerica Corporation and Firstamerica Corporation, which has been organized to receive the property proposed to be transferred under the plan.

It went on to state (Stip. Ex. H, p. 5):

> Based on the equity values as of December 31, 1957 of the assets to be retained by Transamerica and those to be transferred to Firstamerica, the reorganization will result in a roughly equal division of Transamerica's present assets. However, Firstamerica proposes to record the assets transferred to it in its accounts at the book values at which the assets are stated in the Transamerica accounts.
>
> The plan of reorganization contemplates that all paid-in surplus of Transamerica will be allocated to Firstamerica, and that the earned surplus of Transamerica will be divided between the two corporations in proportion to the equity value of the net assets of the respective corporations, with such adjustment of the earned surplus allocation as may be necessary to bring the total allocation of paid-in and earned surplus into agreement with the book value of the assets transferred. The amount of the adjustment so required as of December 31, 1957 would have been $1,560,308. The paid-in surplus allocated

> to Firstamerica will be transferred to Firstamerica's capital stock account to the extent of the par value of the capital stock to be issued by Firstamerica, and the balance will remain as paid-in surplus.

The proxy statement set out a summary of the balance sheet for the taxpayer as of December 31, 1957, and pro forma balance sheets of the taxpayer and Firstamerica as they would have appeared if the proposed reorganization had been effected as of that date. These balance sheets, further summarized and using book values, read as follows (Stip. Ex. H, p. 6):

ASSETS	BALANCE SHEET OF TRANSAMERICA (December 31, 1957)	PRO FORMA BALANCE SHEETS TRANSAMERICA	PRO FORMA BALANCE SHEETS FIRSTAMERICA
Bank stocks	$148,524,203		$148,524,203
Non-bank stocks	50,363,233	$ 50,363,233	
Other securities	12,056,526	12,056,526	
Cash and other receivables	40,000,704	40,000,704	
Total:	$250,944,666	$102,420,463	$148,524,203
Cash to be transferred from Transamerica to Firstamerica		(20,000,000)	20,000,000
Total:	$250,944,666	$ 82,420,463	$168,524,203
LIABILITIES			
Total liabilities:	$ 9,975,410	$ 9,975,410	
CAPITAL			
Capital stock, $2 par value	$ 22,744,044	$ 22,744,044	$ 22,744,044
Paid-in surplus	117,364,957		94,620,913
Earned surplus	100,860,255	51,261,317	49,598,938
Adjustment of earned surplus		(1,560,308)	1,560,308
Total:	$240,969,256	$ 72,445,053	$168,524,203
Total Liabilities and Capital:	$250,944,666	82,420,463	$168,524,203

The proxy statement indicated that the reorganization would reduce the book value (net assets per share of outstanding stock) of the taxpayer's stock from $21.19 per share to $6.37 per share and give Firstamerica's stock a book value of $14.82 per share. (R. 22; Stip. Ex. H, p. 6.)

The plan of reorganization was approved by the stockholders at their April 1958 meeting. (R. 14; Stip. Ex. G.) Thereafter bank stocks having a book value of $148,319,593 and $20,000,000 in cash were transferred to Firstamerica in exchange for all of the stock of the latter corporation (i.e., 11,372,022 shares, a number equal to the number of shares of Transamerica stock then outstanding). Firstamerica stock was immediately thereafter distributed to the taxpayer's stockholders on the basis of one share of Firstamerica stock to each share of Transamerica stock. The reorganization was completed by July 1958. (R. 15, 22; Stip. Ex. I, p. 2.)

No outstanding shares of Transamerica stock were redeemed or transferred and no additional shares of that stock were issued in connection with the reorganization. No change was made in the corporate charter or in the capital stock structure. The taxpayer did not acquire any money or other tangible assets or improve any such assets. The number of Transamerica shares outstanding and the par value thereof remained the same. (R. 15, 21-22.) However, the taxpayer's paid-in surplus of $117,364,957 was eliminated as a result of the reorganization and became the capital stock and paid-in surplus of First-

america. The taxpayer's 1958 annual report to its stockholders recorded this change as follows (Stip. Ex. I, p. 2):

> On June 30, 1958 the carrying value of the Corporation's directly held shares in its majority-owned banks was $148,319,593. The transfer of these assets and $20,000,000 in cash to Firstamerica reduced Transamerica Corporation's assets by $168,319,593, which reduction was offset by the allocation to Firstamerica of all of the Corporation's Paid-in Surplus of $117,364,957 as well as $50,954,636 of its Earned Surplus.

The net effect of the plan of reorganization was summed up in the taxpayer's 1958 annual report as follows (Ex. I, p. 1):

> Our stockholders thus became the owners of two corporations—Transamerica Corporation and Firstamerica Corporation—which together owned precisely the same assets that had been owned by Transamerica immediately before the distribution. The only change was that their equities were evidenced by certificates of stock of two corporations instead of one. Thus the reorganization left intact our stockholders' interests in the substantial values underlying all of the Corporation's investments.

In carrying out its plan of reorganization in 1958, the taxpayer incurred the following obligations (R. 15-16):

Fees and costs paid to transfer agent for mailing Firstamerica stock certificates to the taxpayer's stockholders	$ 76,050.94
Insurance on Firstamerica stock certificates mailed to the taxpayer's stockholders	8,158.99
Attorney fees for:	
Services in obtaining tax ruling	13,500.00
Services in formulating the reorganization plan, processing the plan through the Federal Reserve Board, development of agendas and programming the steps necessary to carry out the plan, and preparation of proxy statement	30,500.00
Printing costs of proxy statement sent to stockholders of the taxpayer	33,432.52
Federal documentary stamp taxes on the transfer by the taxpayer of the Firstamerica stock to its shareholders	14,404.20
Total:	$176,046.65

Expenses incurred by Firstamerica in connection with the plan of reorganization are not included in this itemization. (R. 16.)[2]

[2] The District Court's finding that (R. 23) "None of the claimed expenses relate to the organization of Firstamerica Company [*sic*] or to its corporate charter, capital structure or issuance of its stock" inaccurately reflects the record facts. The tax rulings considered the tax consequences of the reorganization on Firstamerica, the proxy statement deals with the organization of Firstamerica, and the plan of reorganization itself deals with both. Thus, a portion of the legal expenses incurred in obtaining the tax rulings and in developing and processing the plan of reorganization, as well as part of the cost of the proxy statement, in fact "relate to the organization of Firstamerica."

The taxpayer filed a consolidated income tax return for the calendar year 1958 which reflected the income and deductions of its affiliated corporations. (R. 12-13.) Included among the deductions claimed on that return were the expenses listed above, except that a deduction was claimed for the $14,404.20 incurred for documentary stamp taxes on the taxpayer's 1959 return. (R. 16.)

The Internal Revenue Service audited the 1958 consolidated tax return and disallowed the taxpayer's expenses in the amount of $161,642.45. (R. 13; Stip. Exs. A-C.) The Service also audited the taxpayer's 1959 return and disallowed the $14,404.20 incurred for documentary stamp taxes on that return, an obligation, if deductible, deductible only in 1958. (R. 13, 16.) The taxpayer filed a claim for refund for 1958 which the Service denied, and this action for refund was then instituted. (R. 13.)

In the District Court, the taxpayer contended that the dominant aspect of the transaction was a partial liquidation of its bank investments in order to comply with the Bank Holding Company Act and that the expenses incurred were consequently deductible as ordinary and necessary business expenses. (R. 23.) The Government, on the other hand, contended that the dominant purpose of the transaction was a reorganization which benefited the future operations of the taxpayer and consequently that the expenditures made in accomplishing it were nondeductible capital expenditures. (R. 23-24.)

The District Court held that the transaction was a partial liquidation and that the expenses were deduct-

ible as ordinary and necessary business expenses (R. 21-37), and it entered judgment for the taxpayer (R. 41-42). From that action, the Government has filed and prosecuted the instant appeal. (R. 48, 57.)[3]

SPECIFICATION OF ERRORS RELIED UPON

1. The District Court erred in finding and concluding that the taxpayer was entitled to deduct as an ordinary and necessary business expense amounts totalling $176,046.65 which it incurred in 1958 in connection with the divestiture of its bank holding company business.

2. The District Court erred in failing to find and conclude that such amounts constituted nondeductible capital expenditures.

SUMMARY OF ARGUMENT

The taxpayer incurred expenses in divesting itself of its bank stock in order to comply with the provisions of the Bank Holding Company Act of 1956. The Act adopted the policy that holding companies

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[3] Two other issues were presented to the District Court: (1) whether the deductibility of the documentary stamp taxes was properly raised in view of the taxpayer's failure to include it in its claim for refund. (R. 36-37, 43-44); and (2) whether an affiliate of the taxpayer (General Metals Corporation) was entitled to a deduction for money paid and property transferred to the City of Oakland either as a charitable contribution or as a business expense (R. 37-40, 44). The Government has not appealed from the District Court's adverse ruling on the first issue. The taxpayer has appealed from the ruling on the second issue (R. 46, 53-54) which will be discussed in the reply and answering brief to be filed herein by the Government.

owning bank stock should not have interests in other businesses having no close relationship to banks. The taxpayer, having interests in banks and other businesses, elected to become a non-bank holding company and adopted a plan of reorganization whereby it would (1) transfer its bank stock to a corporation organized for that purpose (Firstamerica) in exchange for all of its stock and (2) distribute to its (taxpayer's) shareholders all of the Firstamerica stock. As a result of the reorganization, the taxpayer's former businesses, now vested in itself and Firstamerica, continued to operate—in compliance with the Act. The transaction was tax-free since Congress specially provided (in Sections 1101-1103 of the Internal Revenue Code) for non-recognition of gain in respect to such divestiture transactions.

In holding that the expenses incurred by the taxpayer were deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code of 1954, the District Court erroneously held that the tranaction was essentially a partial liquidation in which it gained no advantage which accrued to the benefit of its future operations. Under the well-established rule that costs of reorganization or recapitalization are nondeductible capital expenditures, these expenditures are not deductible. The transaction, viewed as a whole, was a reorganization. There was a substantial alteration of the taxpayer's business which accrued to the benefit of its future operations as a holding company and there was a substantial impact on its capital accounts. Moreover, even if viewed as a partial liqui-

dation, the essential purpose of the liquidation was compliance with the Act so that the bank business could continue, not termination and liquidation of the bank operation. Consequently, the expenses were capital in nature, benefiting the future operation of the business for an indefinite period of years, not deductible offsets to current operating income.

ARGUMENT

The District Court Erred in Allowing Transamerica to Deduct as Ordinary and Necessary Business Expenses Amounts Incurred in Connection With the Divestment of Its Bank Investments in Compliance With the Bank Holding Company Act of 1956

Section 162(a) of the Internal Revenue Code of 1954, Appendix A, *infra*, provides a deduction against ordinary income for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." This statutory language refers to the recurrent, regular costs of doing business—i.e., the expenses which produce the year's income without detracting from the assets of the business—as distinguished from those expenditures which create assets or secure benefits or advantages which have a useful life extending beyond the year in which incurred. The latter amounts are not deductible business expenses for the purposes of Section 162(a), but are capital in nature and cannot be deducted as an expense of the year in which they were incurred. *Welch* v. *Helvering*, 290 U.S. 111, 113-116; *Commissioner* v. *Tellier*, 383 U.S. 687, 689-690; *United States* v. *Akin*, 248 F. 2d 742, 744 (C. A. 10), certiorari denied, 355 U.S. 956. Cf. Section 263,

Internal Revenue Code of 1954 (26 U.S.C. 1964 ed., Sec. 263).

In this case, the taxpayer incurred expenses in divesting itself of its bank investments in order to comply with the Bank Holding Company Act of 1956, c. 240, 70 Stat. 133, Sections 2-9 (12 U.S.C. 1964 ed., Secs. 1841-1848) (hereinafter sometimes referred to as the Act). The taxpayer accomplished the divestiture by transferring its bank investments to a newly organized corporation in return for all of that corporation's stock and then distributing the stock to its shareholders. (R. 13-15.) This transaction was a reorganization whereby the taxpayer separated its business into banking and nonbanking assets to comply with the Act without altering the substance of its shareholders' interest in them.

In holding that the expenses of divestiture were deductible under Section 162(a) as business expenses, the District Court concluded that they were incurred in a partial liquidation which was accompanied by little or no change in its corporate structure which accrued to the benefit of its future operations. (R. 32-33, 35-36.) This decision ignores the real purpose and effect of the transaction—reorganization to comply with the Act and thereby continue in business. The transaction was a reorganization—the shareholders' interest in the equity values of the assets of the taxpayer did not change—and the expenses consequently are capital expenditures. Moreover, even if the transaction were considered to be a partial liquidation, the expenses incurred still constitute nondeductible capital expenditures because the dominant

purpose of the transaction was to effect a continuation of the business in compliance with the Act, rather than a termination of any shareholders' interest in the assets.[4]

A. *The Bank Holding Company Act*

As a corporation holding substantial investments in banks, insurance companies, and other businesses (Stip. Ex. H, p. 6; Plan of Reorganization, Stip. Ex. E, pp. 8-10, Appendix C, *infra*), the taxpayer was immediately affected by the enactment of the Bank Holding Company Act of 1956. Adopting the policy that holding companies with bank interests ought to confine their activities to the management and control of banks and not engage in the management and control of businesses having no close relationship to banking, the Act made it unlawful for a bank holding company (i.e., a corporation controlling 25 percent or more of the voting stock of two or more banks) to retain control of any voting stock of any company which was not a bank or bank holding company, or to engage in any business other than that of banking. Sections 2 and 4, Bank Holding Company Act of 1956, *supra* (12 U.S.C. 1964 ed., Secs. 1841, 1843); S. Rep. No. 1095, 84th Cong., 1st Sess., pp. 11-14 (2 U. S. C. Cong. & Adm. News (1956) 2482, 2493-

[4] The fact that the expenditures were made to comply with federal law does not alter the test; the question remains whether or not the expenditures were for a benefit or advantage having a life extending beyond the year in which they were incurred. *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444 (C.A. 3d); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 589 (Ct. Cl.).

2495). Section 8 of the Act (12 U.S.C. 1964 ed., Sec. 1847) provides that any company which willfully violates any provision of the Act shall be subject to a fine of not more than $1,000 for each day during which the violation continues; any individual who willfully participates in a violation of the Act is subject to fine of not more than $10,000 or imprisonment for not more than one year, or both.

To comply with the Act, companies holding both bank and non-bank investments had to elect to become purely bank holding companies and divest themselves of their nonbanking investments, or divest themselves of their banking interests and so become non-bank holding companies. The separation could be accomplished either by distributing the bank investments directly to the holding company's shareholders, or by transferring them to a corporation organized for that purpose in return for the stock of the subsidiary and then immediately distributing that stock to the shareholders. S. Rep. No. 1095, *supra,* p. 16 (2 U.S.C. Cong. & Adm. News (1956) 2482, 2497). Congress amended the 1954 Code to provide elaborate measures for tax relief for holding companies making distributions in order to comply with the Act. Sections 1101-1103, Internal Revenue Code of 1954 (26 U.S.C. 1964 ed., Secs. 1101-1103), added by Section 10 of the Act. Shareholders of a corporation electing to become a nonbank holding company recognize no gain on the distribution to them of bank stock or of stock in a new subsidiary corporation organized to acquire the bank assets in question. Section 1101(b). Generally, the distributing corporation recognizes no

gain or loss on the transaction, and the new corporation organized to receive the bank assets recognizes no gain or loss on the transfer of the assets to it. Section 351; Section 368, Appendix A, *infra;* S. Rep. No. 1095, *supra,* pp. 16-18 (2 U.S.C. Cong. & Adm. News (1956) 2482, 2497-2500. The Act made no special provision for allowance of the type of deductions claimed here.

Electing to divest itself of its bank stock, the taxpayer adopted a plan of reorganization whereby (1) a new corporation would be organized and the bank stock transferred to it in exchange for all of its stock, and (2) the taxpayer would immediately distribute all of the stock of the subsidiary to its (taxpayer's) stockholders.[5] This plan was carried out. Firstamerica Corporation was organized and, on or about June 30, 1958, the taxpayer transferred its bank stocks, having a book value of $148,000,000 and $20,000,000 in cash to Firstamerica and immediately, in compliance with the Act, distributed the Firstamerica stock received in exchange for the bank stock and cash to its stockholders. (Stip. Ex. I, pp. 1-2.) The effect of the transaction, utilizing December 31, 1957, book values, may be summarized as follows (Stip. Ex. H, p. 6):

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[5] S. Rep. No. 1095, 84th Cong., 1st Sess., p. 17 (2 U.S.C. Cong.&Adm. News (1956) 2482, 2499) (nonrecognition treatment is available where the bank stock "is first transferred to a wholly owned subsidiary expressly created for that purpose and the stock of the subsidiary is then immediately distributed to the shareholders of the parent").

	BALANCE SHEET OF TRANSAMERICA (December 31, 1957)	PRO FORMA BALANCE SHEETS	
		TRANSAMERICA	FIRSTAMERICA
ASSETS			
Bank stocks	$148,524,203	....	$148,524,203
Cash and other investments	102,420,463	$102,420,463	....
Cash to be transferred to Firstamerica	....	(20,000,000)	20,000,000
	$250,944,666	$ 82,420,463	$168,524,203
LIABILITIES	$ 9,975,410	$ 9,975,410	....
CAPITAL			
Capital stock	$ 22,744,044	$ 22,744,044	$ 22,744,044
Paid-in surplus	117,364,957	....	94,620,913
Earned surplus	100,860,255	51,261,317	49,598,938
Adjustment of earned surplus	....	(1,560,308)	1,560,308
Total:	$240,969,256	$ 72,445,053	$168,524,203

The reorganization in fact eliminated the taxpayer's paid-in surplus of more than $117,000,000 and reduced its earned surplus from about $100,000,000 to about $51,000,000. (R. 22; Stip. Ex. I, p. 2.)

As a result of the reorganization, the taxpayer's stockholders retained the same equity in the business as before, but the investments were now divided between the two corporations in such a way that the business could continue, now being in compliance with the Bank Holding Company Act. The taxpayer's 1958 annual report to its stockholders summed it up as follows (Stip. Ex. I, p. 1):

> Our stockholders thus became the owners of two corporations—Transamerica Corporation and Firstamerica Corporation—which together owned precisely the same assets that had been owned by Transamerica immediately before the distribution. The only change was that their equities were evidenced by certificates of stock of two corporations instead of one. Thus the reorganization left intact our stockholders' interests in the substantial value underlying all of the Corporation's investments.

B. ***The expenses of divestiture are not deductible***

In carrying out the plan of reorganization, the taxpayer incurred expenditures totalling $176,046.65 for (1) transfer agent fees, (2) insurance on Firstamerica stock certificates while being mailed to Transamerica stockholders, (3) attorney fees for services in obtaining tax rulings and in formulating and processing the plan of reorganization, preparing for its performance, and preparation of the proxy statement,

(4) printing costs for the proxy statement, and (5) federal documentary stamp taxes on the transfer by Transamerica of the Firstamerica stock to its stockholders. (R. 15-16.) The District Court erred in holding that these expenditures are deductible as business expenses under Section 162(a), because they represent nondeductible capital expenditures of either (1) a reorganization, or (2) a partial liquidation whose principal purpose was a readjustment, not a termination, of the taxpayer's business in order to comply with the Act and thereby continue in business.

1. *Reorganization*

It is well established that expenses incurred in reorganizing a corporation constitute nondeductible capital expenditures. The rule is based on the principle that the corporation has acquired a benefit or advantage which, like organizational expenses, benefits the corporation in its future operations for an indefinite period.[6] It is not necessary that the reor-

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[6] Regarding the nondeductibility of reorganization expenses, see *Motion Picture Capital Corp.* v. *Commissioner*, 80 F. 2d 872 (C.A. 2d); *Skenandoa Rayon Corp.* v. *Commissioner*, 122 F. 2d 268, 271 (C.A. 2d), certiorari denied, 314 U.S. 696; *Missouri-Kansas Pipe Line Co.* v. *Commissioner*, 148 F. 2d 460, 462 (C.A. 3d); *International Building Co.* v. *United States*, 199 F. 2d 12, 26 (C.A. 8th), reversed on other grounds, 345 U.S. 502; *Odorono Co.* v. *Commissioner*, 26 B.T.A. 1355.

Organizational expenses are capital expenditures. *Guarantee Bond & Mortgage Co.* v. *Commissioner*, 44 F. 2d 297 (C.A. 6th). Since 1954, certain organizational expenses may be amortized over a five-year period. Section 248, Internal Revenue Code of 1954 (26 U.S.C. 1964 ed., Sec. 248); Section 1.248-1, Treasury Regulations on Income Tax (1954 Code) (26 C.F.R., Sec. 1.248-1).

ganization concern the corporate structure of the taxpayer-corporation (*Missouri-Kansas Pipe Line Co.* v. *Commissioner*, 148 F. 2d 460 (C. A. 3d)) (expenses of distributing subscription warrants for subsidiary's stock are not deductible), or even that some tangible asset be acquired (*General Bancshares Corp.* v. *Commissioner*, 326 F. 2d 712, 716 (C. A. 8th), certiorari denied, 379 U.S. 832) (expenses of issuing stock dividends are not deductible).

That the transaction in this case was a reorganization and was so regarded by all is evident from the minutes of the board of directors when the plan was adopted (Stip. Ex. E, pp. 8-10, Appendix C, *infra*), the proxy statement (Stip. Ex. H, pp. 1-7), the minutes of the shareholders' meeting when the plan was approved (Stip. Ex. G, pp. 2-7), and the 1958 annual report (Stip. Ex. I, pp. 1-2). The transaction effectively rearranged the taxpayer's businesses, separating the banking and nonbanking parts so that they could be pursued in compliance with the Bank Holding Company Act, but not altering the substance of the shareholders' equity in them. Indeed, the sole change from their standpoint was that their equity interest was evidenced after the transaction by two pieces of paper (stock certificates) instead of one. (Stip. Ex. I, p. 1.) The transaction did in fact alter the taxpayer's corporate structure; it eliminated the bank investments which would have prevented it from continuing to do business as a holding company. Finally it had a dramatic impact on the taxpayer's capital structure by eliminating paid-in surplus of

more than $117,000,000 and reducing earned surplus by $49,000,000. (R. 22; Stip. Ex. I, p. 2.)

Although the taxpayer itself consistently referred to the divestiture transaction as a "reorganization", it safely may be predicted that the taxpayer will contend that it was not a "reorganization" within the meaning of the Internal Revenue Code. Section 368 (a) (1) (D) includes in the definition of a "reorganization" the transfer by a corporation of part of its assets to another corporation if, immediately after the transfer, the transferor or its stockholders are in control of the corporation to which the assets have been transferred, provided further that the stock of the corporation receiving the assets is distributed in a transaction qualifying under Section 354, Section 355, or Section 356 of the 1954 Code. Admittedly, there are technical difficulties in threading the facts of this case through that particular needle, but the point to be stressed is that the transaction here involved was made tax-free under a specially tailored set of provisions (Sections 1101-1103.) The latter, like the general reorganization provisions of the Code, reflect Congressional policy that when the same people continue to own the same businesses in different corporate forms, there is no sound basis for attaching tax consequences to the changeover. Viewed in that light, it should make no difference whether the "reorganization" qualifies for non-recognition treatment under Section 368(a)(1)(D) as well as under Sections 1101-1103. If that much be accepted, then the judicial decisions on the question of whether "reorganization" expense is a currently deductible item are fully applicable here.

Following along the same line, it may be observed that the District Court unwarrantedly concerned itself with searching out some benefit to the taxpayer stemming from the reorganization. As an elementary proposition, corporate officers do not authorize outlays of cash which neither benefit nor are intended to benefit the corporation—if they do, the minimum requirement for deductibility of ordinary and necessary business expenses under Section 162(a) remains unsatisfied. *Welch* v. *Helvering*, 290 U. S. 111. In any event, however, it seems unwise to insist upon an objective showing that the taxpayer acquired something in the nature of a new valuable asset by reason of the expenditures here involved. In many corporate "reorganizations" of more conventional stripe, particularly those involving corporate divisions, the primary corporation may wind up with diminished assets, but the assumption to be made is that the transaction was of advantage either to the corporation or to its shareholders or it would not have been made. All of the foregoing reduces itself to the simple proposition that the expenditures here in dispute either produced (or were intended to produce) a benefit to the taxpayer or they could not possibly qualify for deduction under Section 162(a). The only question which remains is whether the expenses of producing such benefit extend into the future for an indefinite period of years. In the case at bar, it clearly appears that the "reorganization" expenses here involved related to a permanent change in the structure of the taxpayer's business, and that, like

"reorganization" items generally, they should be capitalized and not deducted.

2. *Partial liquidation*

In treating this case as one involving a partial liquidation, the District Court looked at one facet of the transaction and ignored the whole, but, even if viewed as a partial liquidation, deduction of the expenses in question should have been disallowed. As the District Court correctly noted (R. 32-33), the test of deductibility in partial liquidation cases is whether or not the substance of the transaction in which the expenditures were incurred was to benefit the future operations of the corporation. Thus, in *Mills Estate* v. *Commissioner*, 206 F. 2d 244 (C. A. 2d), a corporation holding both real estate and stock investments had decided to terminate its real estate business and had disposed of its real estate. It then became subject to the personal holding company tax and, in order to reduce its taxes, it distributed the proceeds received from the disposition of the real estate. It then reduced its authorized capital stock in order to comply with state law. The Second Circuit, considering the deductibility of attorney fees incurred in distributing the cash proceeds and in altering the capital structure, held that the transaction should be viewed as a whole and the expenses incurred analyzed in respect to the operation of the business. In concluding that the expenses were nondeductible capital expenditures, the court reasoned as follows (206 F. 2d, p. 246):

> This taxpayer, having decided to go out of the real estate operation part of its business and having turned its real estate into cash, underwent a recapitalization to give itself the capital structure it determined was best suited to carrying on that part of the business it was to continue. The services for which the attorneys were paid were all necessary steps to attain that end. What occurred was essentially a reorganization—a change in the corporate structure for the benefit of future operations—and the expenses of that sort of a corporate change are not deductible as ordinary and necessary expenses in carrying on a trade or business. * * * [Citations omitted.] They are instead a part of the expenditure needed to give the corporation an intangible asset which we may call its altered corporate structure; and, as were the costs of its original organization, these expenditures were capital in nature.

And see *Farmers Union Corp.* v. *Commissioner*, 300 F. 2d 197, 200 (C. A. 9th) ("Expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary businesses expenses").

On the other hand, where the principal concern was to retire one of the stockholders, the Eighth Circuit has held that the essence of a transaction whereby the corporation distributed part of its assets to the stockholder in return for his stock was a partial liquidation, not an improvement benefiting the future of the business. Consequently, it held that the costs incurred in the redemption and distribution were de-

ductible business expenses. *Gravois Planing Mill Co.* v. *Commissioner*, 299 F. 2d 199.

This case is governed by the principle adopted in the *Mills Estate* case—i.e., that the expenses were incurred in an effort to enable the taxpayer's shareholders to preserve their interests in the entire business operated by the taxpayer. The record facts yield but one inference—that the taxpayer divested itself of its bank business and thrust it into Firstamerica in order that its shareholders might continue to enjoy the benefits accruing to them from the operation of the bank and non-bank business. The divestiture was not connected with a termination of part of the shareholders' interest in the assets. Unlike the *Gravois Planing Mill* case, *supra*, the shareholders were not terminating their investment in the business. Instead, the whole purpose of the transaction was to continue the business and the expenditures are, consequently, not deductible.

In analyzing the case, the District Court considered the consequences of the situation if the taxpayer had sold the bank assets for cash and distributed the proceeds to its shareholders, or had distributed the bank assets in kind, and reasoned that in such cases the taxpayer would have been entitled to deduct the cost of making the distribution. (R. 31.) However, it is not clear that a deduction would be allowed in such cases. If the bank assets were distributed to comply with the Bank Holding Company Act and not to terminate the business, then, as here, the expenses should be capitalized. See *Mills Estate* v. *Commissioner, supra; Farmers Union Corp.* v. *Commissioner*,

supra. Moreover, in cases where a cash dividend is distributed, there is, unlike here, no question of the continuation of the business of the taxpayer and of the maintenance of the shareholders' undiminished equity interest in the business.

CONCLUSION

For the foregoing reasons, the judgment of the District Court holding that the expenses of divestiture were deductible business expenses should be reversed.

Respectfully submitted,

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
GILBERT E. ANDREWS,
J. EDWARD SHILLINGBURG,
Attorneys,
Department of Justice,
Washington, D. C. 20530.

Of Counsel:

CECIL F. POOLE,
United States Attorney.

RICHARD L. CARICO,
Assistant United States Attorney.

APRIL, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: This .... day of April, 1967.

J. EDWARD SHILLINGBURG

APPENDIX A

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.* There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * *

(26 U.S.C. 1964 ed., Sec. 162.)

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

* * * *

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement

negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

* * * *

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * *

(26 U.S.C. 1964 ed., Sec. 355.)

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*—

(1) *In general.*—For purposes of parts I and II and this part, the term "reorganization" means—

* * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination there-

of, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * *

(26 U.S.C. 1964 ed., Sec. 368.)

APPENDIX B

Statement in Compliance With Rule 18 Regarding Exhibits

The only exhibits in the record are Exhibits A through L attached to the stipulation of facts. (R. 11-18.) Pursuant to the stipulation of the parties herein, they have not been duplicated. (R. 61-62.)

APPENDIX C

Regular Meeting of the Board of Directors of Transamerica Corporation, San Francisco, California, September 19, 1957 (Stip. Ex. E., pp. 8-10):

Plan of Reorganization

"Transamerica Corporation (hereinafter referred to as Transamerica) will cease to be a bank holding company, but will continue to own and manage its insurance and other non-banking businesses. To this end, it will take the following steps:

(1) Transamerica will organize under Delaware law a new corporation to be known as Firstamerica Corporation (hereinafter referred to as Firstamerica) which will function as a registered bank holding company. Firstamerica will be authorized by its charter to engage in the business of managing and controlling banks and of furnishing services to or performing services for its subsidiary banks. Its home office and principal place of business will be in San Francisco, California. Its charter will authorize the issuance of a single class of common stock with a par value of $2.00 per share in an amount of 25,000,000 shares, and Firstamerica will initially issue and have outstanding an amount equal to the number of shares of Transamerica outstanding, as further described below.

(2) Preliminary to an exchange of properties between Transamerica and Firstamerica, each of Transamerica's majority-owned banking subsidiaries (other than the First National Bank of Arizona) which now owns or controls more than 5% of the stock of any non-banking company, or which in any other manner controls any non-banking company, will liquidate,

transfer, or reduce to 5% or less its control or ownership of, each of these non-banking companies. No such action shall be taken with respect to the shares of the First Bank Building Corporation now owned and controlled by the First National Bank of Arizona.

(3) Transamerica will thereafter transfer to Firstamerica $20,000,000 in cash and all of the stock it directly holds in each of its majority-owned banking subsidiaries. Based on Transamerica's ownership of such stock as of September 20, 1957, Firstamerica will own immediately after the transfer the following bank stocks:

		Transferred to Firstamerica	
Bank	Total Shares Outstanding	Shares	Per Cent Outstand Shares
First Western Bank and Trust Company	2,213,942	1,622,431	73.2
First National Bank of Portland, The	1,600,000	941,044	58.8
Walker Bank & Trust Company	189,468	171,557	90.5
National Bank of Washington	358,625	200,824	55.9
Bank of Idaho	135,000	133,430	98.8
First National Bank of Nevada	500,000	480,719	96.1
Bank of Nevada	9,000	6,593	73.2
First National Bank of Arizona	920,000	537,540	58.4
Southern Arizona Bank and Trust Company	250,000	231,325	92.5

	Total Shares Outstanding	Transferred to Firstamerica	
		Shares	Per Cent of Outstanding Shares
an National Bank ɪnver, The	20,000	18,988	94.9400
ood State Bank	22,500	21,650	96.2222
Iational Bank in Collins, The	2,500	2,252	90.0800
f New Mexico	45,000	41,165	91.4778
tate Bank at p	1,500	1,373	91.5333
ınty State Bank	19,200	12,744	66.3750
State Bank	18,000	9,630	53.5000
'e National Bank	16,000	12,258	76.6125
f Glacier County	1,500	1,305	87.0000
National Bank ılispell, The	40,000	35,725	89.3125
a Bank	4,000	3,639	90.9750
National Bank,	35,000	32,483	92.8086
'ational Bank ıramie, The	1,000	930	93.0000
'ational Bank verton, The	5,500	5,050	91.8182

(4) Firstamerica will issue to Transamerica in exchange for the cash and bank stocks described in paragraph (3) above, a total of 11,372,022 shares of its common stock constituting all of its common stock issued and outstanding at this time. These shares will be distributed immediately share-for-share pro rata to Transamerica's stockholders of record as of a date to be subsequently determined by the Board of Directors. The certificates evidencing the shares of Firstamerica will not bear any statement purporting to represent the shares of Transamerica. The ownership, sale and transfer of the shares of Firstamerica and of Transamerica will not be conditioned in any manner upon the ownership, sale or transfer of shares of the other, nor will the shares of either be held in trust for the benefit of the other corporation or its stockholders.

(5) After the exchange and distribution, Transamerica and Firstamerica will have no common officers or directors.

(6) Transamerica will submit this plan to the Board of Governors of the Federal Reserve System for certification under the provisions of the Bank Holding Company Act at the earliest practicable date following approval of the Plan by Transamerica's Directors. Upon receipt of the required certification, the plan will be submitted to the Internal Revenue Service for appropriate tax rulings. Upon receipt of favorable tax rulings, the plan will be submitted to Transamerica's stockholders for their approval at the annual meeting on April 24, 1958, and the exchange and distribution is to be made effective on June 30, 1958, or as soon as practicable thereafter.

(7) All other necessary regulatory approvals will be obtained for each step in the reorganization program.

Application will be made for registration of the shares of Firstamerica under the Securities Exchange Act of 1934 and for listing of the Firstamerica shares on the Pacific Coast and New York Stock Exchanges. Firstamerica will make application to the Board of Governors of the Federal Reserve System for permits to vote its stock in each of its member bank subsidiaries."

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